Economic & Market Update, December 2017

The Spark

By Richard Morey

This month there is a lot of ground to cover, so we'll just give the key points on each topic. I'll begin with the end; namely, where will the stock market end up when the current insanity ends? The answer is a loss of approximately 64%, which will put the Dow Jones Industrial Average at 8,800 and the S&P 500 at 950. It makes no difference how high it goes along the way, in the end markets come back to their fair value. And no, neither investor enthusiasm nor central banks have permanently eliminated gravity!

Taxes

First, I need to express the caveat that my analysis of the tax bill comes primarily from former Republican lawmakers and Reagan administration officials. I say this because our readers need to understand this is not a partisan perspective when stating this is the single worst tax bill in history. Approximately two-thirds of middle-class taxpayers get a relatively small cut, while the remaining one-third get a tax increase. But those who do get tax cuts will see them expire in the future. In contrast, the wealthiest of individual taxpayers see the estate tax and alternative minimum tax permanently eliminated. Even worse, from my geographically biased perspective, relatively higher income middle-class California residents will tend to fall in the group that sees their taxes rise.

Of course, the changes on individual tax rates – other than the elimination of the estate tax and alternative minimum tax – has little or nothing to do with why Congress is attempting to pass this bill. I consider all the changes to the individual taxes to be something like a shell game, i.e. move around all the brackets and deductions to make it look like a lot is happening for the middle class when in reality they get little if anything.

The primary impact of the bill is to reduce corporate taxes. The idea is that, if corporations pay less in taxes, they will then be able to invest more in their businesses to grow. Unfortunately, tax cuts only work to stimulate when they remove or reduce a constraint. Corporations presently have no constraint, at all, on their ability to invest in their businesses. To the contrary, U.S. corporations have been taking most or all of their profits to purchase back their own stock. Even if they have no earnings, even a company on the verge of bankruptcy can borrow money for very little should they want to expand.

Perhaps counter-intuitively, based on data from the last 75 years, a lower corporate tax rate has been associated with lower economic growth, not higher. Michael Lebowitz at 720Global studied the relationship between corporate tax rates and economic growth and found the following: "**Based on statistical regression, every 1% decrease in the effective tax rate should diminish GDP growth by 0.12%...** The largest tax cut ever was in 1986. However, the average annualized GDP growth rate in the five years before the major statutory tax reduction in 1986 was 3.90%. In the five years following the tax cut, the average annualized growth was reduced by more than half to 1.93%." This is a very short summary, with the complete report clearly revealing lower corporate taxes deliver no economic benefit.

Those in favor of the corporate tax rate change say our 35% rate on corporate taxes is far above most others in the world. This is indeed true, but it's also meaningless because few corporations pay this rate. In reality, our corporations as a whole already pay little over 20% due to an encyclopedia of deductions, exemptions and loopholes.

This doesn't mean we don't need corporate tax reform, as we should lower the top rate to 20%, or at most 25%. But we should simultaneously remove most of the loopholes so total corporate taxes paid go up, not down. At this time corporate taxes account for a dramatically smaller piece of the total tax pie than at nearly any time in the last 100 years. This is a troublesome distribution for an economy in which 70% of our growth is dependent on consumer spending.

Most importantly, we now have over $20 trillion in government debt, and *before* these tax changes we were already looking at $1 trillion in annual debt increases over the next decade. And every penny of the corporate tax cuts is paid for with more debt on top of the $30+ trillion we'll have by the time the individual tax cuts expire. This is economic sin. At the end of the day, this entire tax package consists of shoveling more money to the wealthiest and transferring the bill, which we absolutely cannot afford to pay, to the entire nation. Just like I was aghast at how the Obama administration bailed out (and continued to bail out) the largest banks, I am similarly disgusted with this tax bill. In both cases the wealthiest and most powerful benefitted greatly, while the middle class was left to hold the bag.

This tax bill is good for the stock market, on a very short-term basis. I say very short-term because, historically, there has been no relationship at all between the level of corporate taxes and after-tax corporate profits. This actually makes sense when you consider individual taxes and corporate taxes are the only way to pay for government expenses. If corporations pay less, either individuals pay more or we borrow more to cover the difference. But higher individual taxes and/or higher debts ultimately lead to less consumer spending which hurts corporate profits.

The Economy

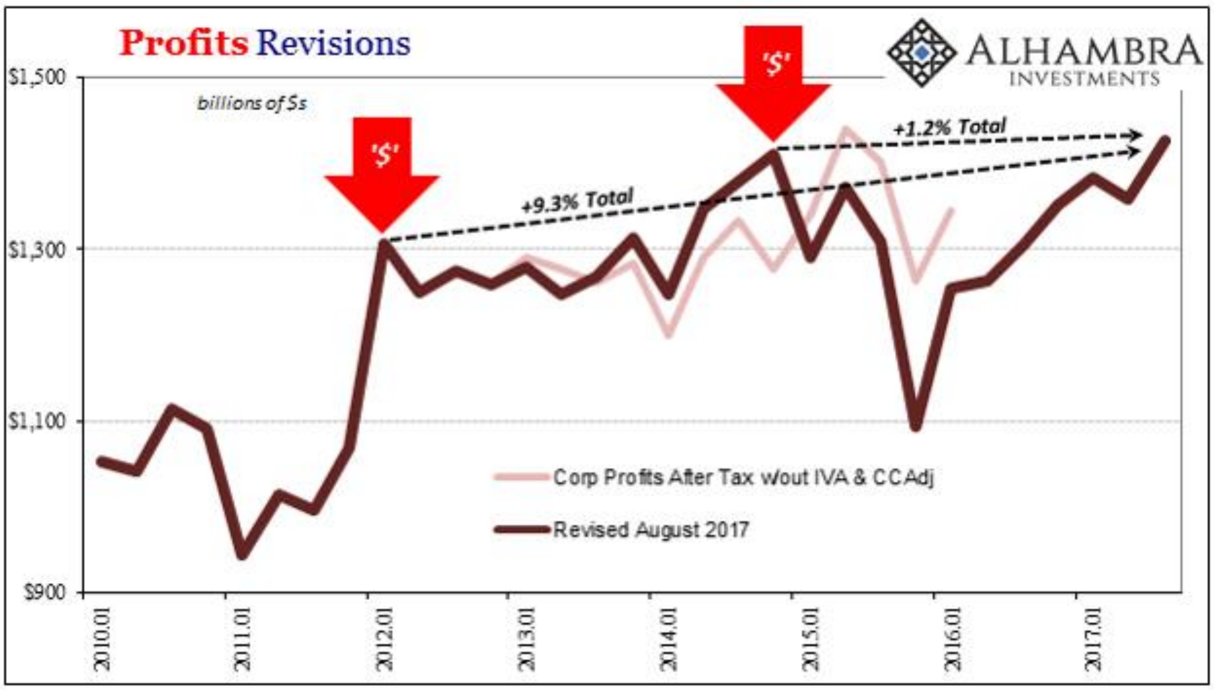
Exactly one chart explains the changes in the economy this year. If we listen to the financial media all we're hearing is how the entire world economy is now taking off. Yes, we've heard this many times in recent years, and it has never happened. It definitely won't occur this time either. The entire, modest upswing in the world and U.S. economy this year has been due to China's massive new debt explosion that began in the middle of last year and was designed to make sure their economy was rising when they reelected their top officials at their five year Congress in October.

The chart below shows this clearly. The blue line shows the growth in their lending, while the red and green bars shows surprises, up or down, in their economic numbers. In early to mid 2015 the markets were deeply worried China was going to bring the entire world economy down. But with their Congress coming up this year, last June they began to push new loans out to their companies at a rate of 40% of yearly GDP. But as you can see, they started to taper this in April, and this pullback is now expected to continue through next year. This means the world, and U.S., economy will soon start to recede to the lackluster rate we've seen for years now.

Looking forward, at some point we will obviously have another recession. In addition to China, the rest of the world's central banks are also poised to begin removing money from the financial system next year while the Federal Reserve Board is also likely to continue raising short-term interest rates. Combined, this will almost certainly be sufficient to push us into recession. For some difficult to discern reason, nearly every year first quarter growth has been quite weak. With central banks now just beginning to unwind their money-printing and other extraordinary measures, this next time the economy may just continue to go down from the first quarter on.

Corporate Earnings

U.S. corporate earnings have risen a total of 1.2% since late 2014, which is quite close to no growth in three full years. They plummeted when oil prices were cut in half, then they recovered these losses when oil then doubled in price. However, the net is basically no growth for three full years. Perhaps even worse, since January of 2012, or for six years, they have only risen 9.3%. This comes to 1.55% a year.



With such lackluster earnings growth, one would expect the stock market to have crashed over the last 6 years. Obviously the exact opposite occurred. But it will crash, and the further it rises the larger the ensuing crash will be.

The Spark

In the past I have repeatedly said it's impossible to know what will bring the stock market down. This is because there are hundreds of economic, political, and market actions which could trigger it. In reality, once the stock market is in an historic bubble, the outcome is already determined. The event or events which are later given as the cause of the bubble popping are unpredictable and typically surprising. This time will likely be the same. Ultimately, the only reason the stock market hasn't plummeted long before now is purely psychological. Investors have decided stocks can now only go up - forever.

While we really don't even try to guess what will end up being the stated causes of the coming stock market crash, there is one huge financial oddity likely to make this instance unique - uniquely ugly in the beginning. This involves the phenomenal growth of investment strategies involved in something called selling volatility.

I'm not going to go into many details, as this topic is quite complicated. The simplest version involves investors who are selling the VIX short. The VIX is a measure of stock market volatility or risk. When investors sell it, this means they are betting against risk hitting the stock market. As a result of the most sales ever, the VIX has been at its lowest level ever. (Yes, this means investors actually believe this is the safest stock market in history!!) A very common practice today is to sell the VIX, take the proceeds and then buy more stocks - on margin. But the VIX could, and will, double at some point in less than one week. Anyone who has sold it is likely to lose approximately 85% on this investment. This will be happening when the stock market has started to go down. So these investors will lose 85% on their VIX sale while the 150% they have in stocks (as they borrowed 50% to buy more stocks) is also going down. They will then have to sell stocks to pay back their margin loans, and this selling will then drive the VIX lower, leading to more losses. In short order these investors will end up losing everything in their accounts.

While complicated in execution, in principle this isn't hard to understand. These investors are essentially selling insurance to other investors against the stock market going down. They are then taking the "premium" they receive for selling insurance against possible stock market losses and using the money to buy more and more stocks for themselves. So whenever the stock market goes down they have to pay off those to whom they sold the insurance, and at the same time all their stocks will be losing money.

I just described quite a few billions of dollars worth of investments, most of which are held by individual investors. It gets scary when you know institutional investors are doing essentially the same thing - with somewhere between $500 billion and $2 trillion! But these institutions are using much more leverage such that they won't just lose everything but are expected to lose 300-800% of everything in their accounts. Obviously if you lose over 100% of your money you are bankrupt, and when you lose 800% you are seriously, seriously bankrupt. Somebody will have to come up with a mind-boggling amount of money to cover the losses, and that somebody is likely to be large financial institutions.

What this means is that the next time the stock market begins to go down, in short order it is likely to crash very, very quickly. It will go down 5-10% over a week or two, which will be enough damage to all these accounts which have sold volatility such that they will be forced to sell all their stocks at once. As a result, shortly after the stock market turns down, the stock market will probably drop **20% in one day**. This will be a one-day loss of nearly 5,000 points on the Dow. And the man who originally created the strategy being used by institutions to sell volatility recently guaranteed this is going to occur.

In the end, investors will have the experience of the man who, when asked how he went bankrupt, replied, "Slowly at first, then all at once."

Whether slowly, or all at once, I'm sure all our readers would dearly love to know exactly when this will begin? Unfortunately, this particular question remains unanswerable. If we knew the answer, we would be 150% invested in stocks until the day before they were to begin their fall! Typically the stock market does well in December, so we're not holding our breath for anything to change dramatically this month. However, by sometime in February there is a good chance we'll see the stock market at least begin to shake. Of course, it could begin tomorrow, or after February. We only know two things for certain on this topic. The first is that each day brings us a day closer to the end. And the second is that the stock market will end in one of the largest crashes in our nation's history.